Federal Home Loan Bank Seattle

Managing Interest Rate Risk in an Uncertain Environment

Phill S. Rowley
President & CEO, Treasury Management Services, Inc.
Faculty, Pacific Coast Banking School

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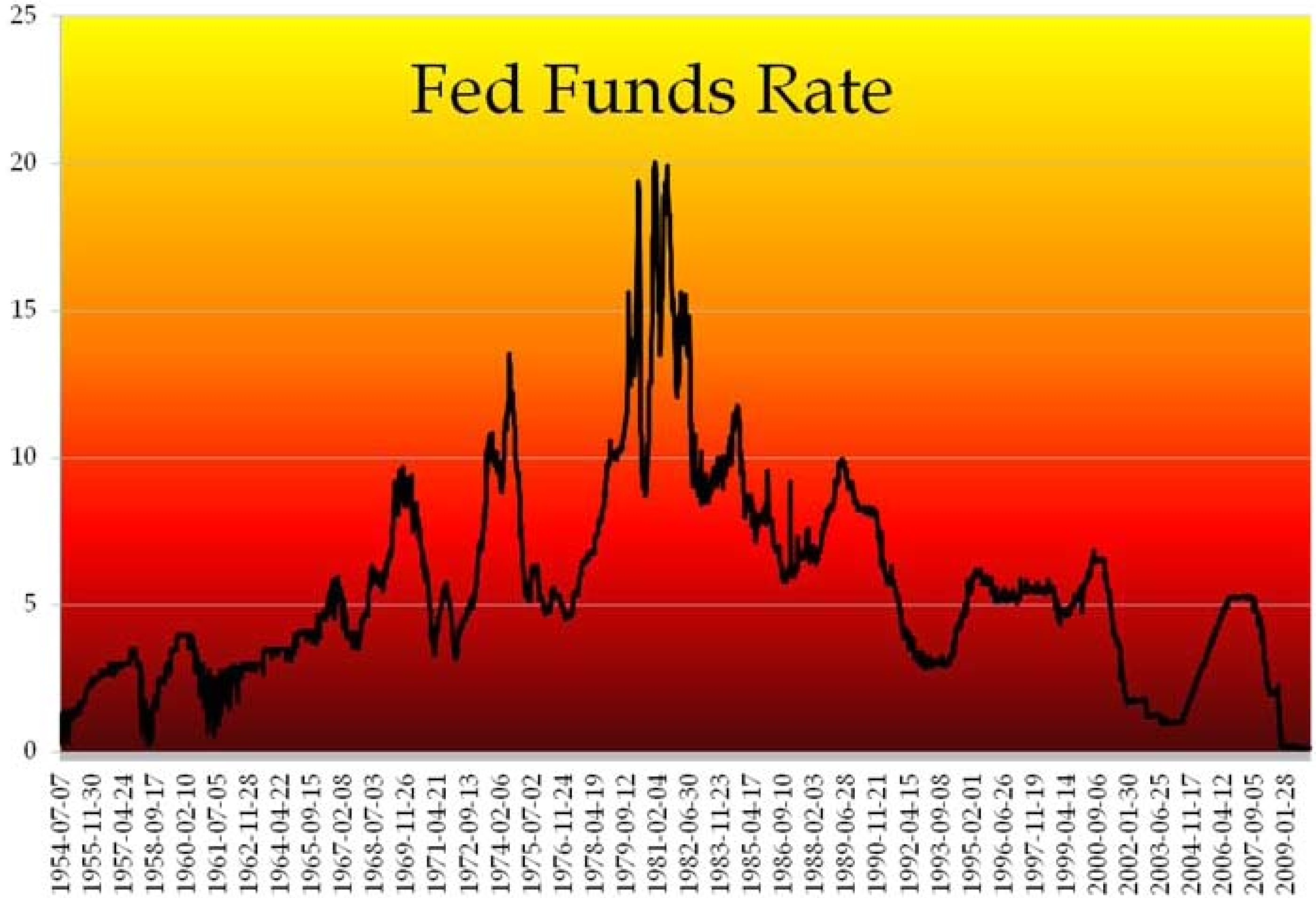
Today’s presentation will include:

- Comments on the new interagency guidance
- The role of governance in interest rate risk management
- Measurement tools
- Action steps and strategies

Uncertainty



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Interest Rate Sensitivity

Allows for controlling interest rate risk (The “S” in the CAMELS rating) and or taking advantage of anticipated interest rate movements

Advisory on Interest Rate Risk Management – January 6, 2010

- Corporate Governance
- Policies & Procedures
- Measuring & Monitoring Interest Rate Risk
- Risk Mitigating Steps

Corporate Governance

- Board of Directors
  - Understand and be regularly informed about the level and trend of the interest rate risk in their institutions
  - Oversee the establishment, approval, implementation and annual review of interest rate risk strategies, policies, procedures and limits
- Management should maintain
  - Appropriate policies, procedures and internal controls
  - Comprehensive systems and standards for measuring interest rate risk
  - Sufficiently detailed reporting processes to inform management and the board as to the level of interest rate risk exposure

Policies and Procedures

Policies and procedures should be comprehensive and should govern all aspects of interest rate risk from *both* a short-term and long-term perspective

Measuring and Monitoring

- Gap Analysis – Okay for small and less complex institutions
- Earnings at Risk – Better than Gap and now affordable to smaller institutions
- Economic Value – More complicated but has added features

Risk Mitigating Steps

- On Balance Sheet
  - Asset and/or Liability side
    - Volume
    - Mix
- Off Balance Sheet
  - Derivatives
    - Futures
    - Options
    - Swaps

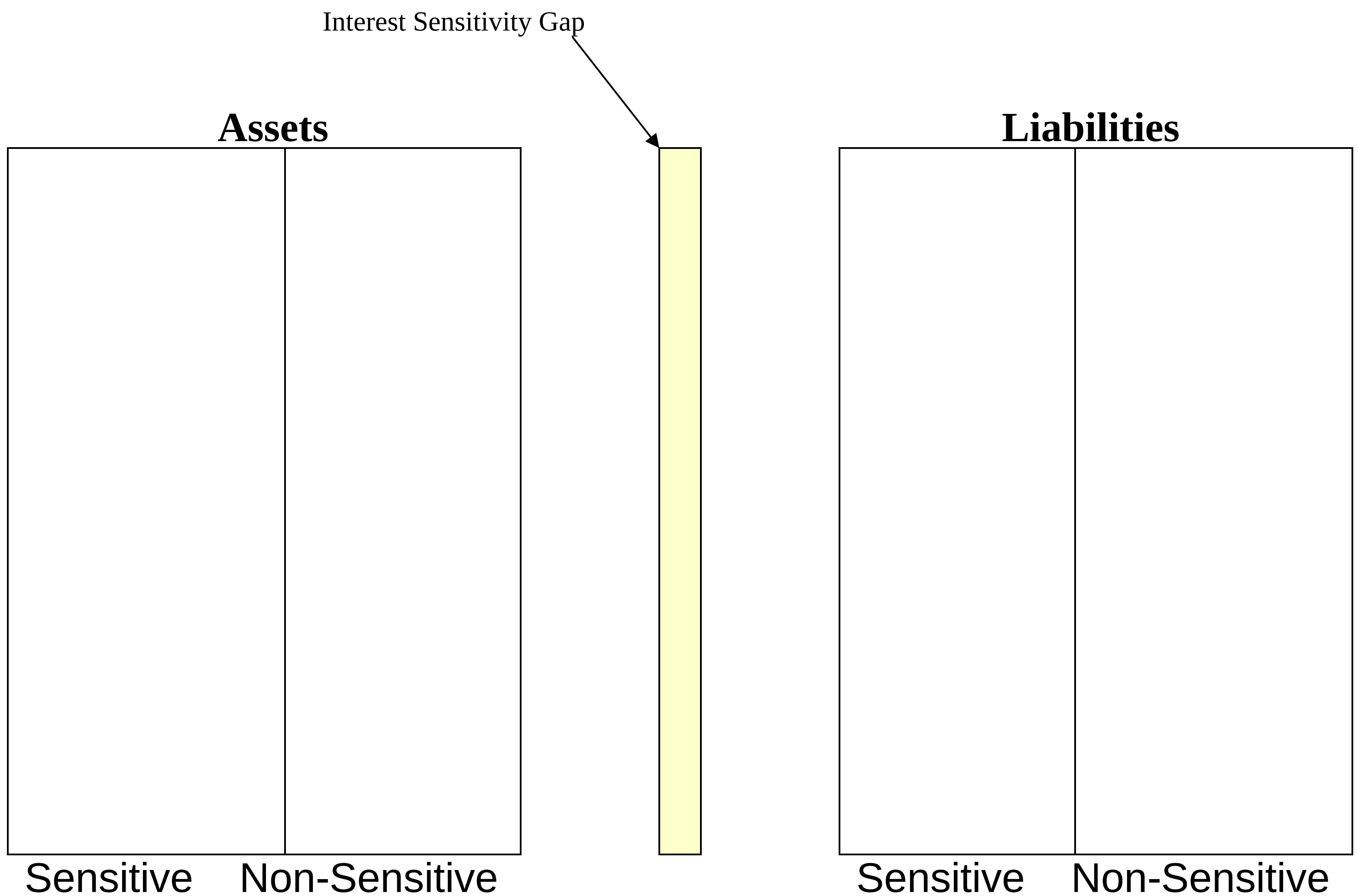
All of this is NOT new

"The financial regulators are issuing this advisory to remind institutions of supervisory expectations regarding sound practices for managing interest rate risk (IRR)."

Where We Are Today

- We have the policies and procedures in place
- In most cases we have corporate governance in place
- We have measuring and monitoring techniques available
- Risk mitigating tools are available to us.
- What we may not have is:
  - A full understanding of what the information is telling us

Gap Analysis



Gap Analysis

- Pros:
  - Relatively simple to calculate
  - Easy to understand
  - Original method used, therefore more accepted by banks and regulators
- Cons:
  - Does not take into account basis risk
  - Often viewed as “static”
  - Oversimplification of interest rate risk

Simulation (Earnings at Risk)

- Computer modeling to incorporate:
  - Cash Flows
  - Re-Pricing Opportunities
  - Multiple Interest Rate Scenarios
- Enables stochastic analysis
  - Another way of saying “developing a frequency distribution of anticipated outcomes”

Simulation (Earnings at Risk)

- Pros:
  - Relatively easy to calculate
  - Easy to understand
  - Realistic view of impacted earnings
- Cons:
  - Often viewed as “static”
  - Oversimplification of interest rate risk
  - Only considers time being analyzed

Economic Value

- Steps:
  - Determine effect to market value of assets with immediate increase and decrease in interest rates
  - Determine effect to market value of liabilities with immediate increase and decrease in interest rates
    - Change in the difference between the value of the assets and liabilities represents risk

If all the assets and liabilities have the same pricing characteristics, the net change is zero.

Economic Value

- Pros:
  - Ensures view of interest rate for total duration of balance sheet
  - Meets regulatory requirements
- Cons:
  - Complicated to understand
  - Requires sophisticated asset/liability model

Summary

The regulators have brought to our attention there is going to be increased emphasis on the “S” in CAMELS and we need to pay attention to that notice.

Moreover, we should be actively managing our balance sheets to protect against interest rate risk but also to take advantage of potential interest rate movements and act accordingly within guidelines set by management and approved by a knowledgeable board of directors.

Questions?

Phill Rowley
(360) 896-2945
stanley600200@aol.com
treasurymgmt.com

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